

What Is The Exchange Rate Channel Of Monetary Policy Transmission?

The central bank use monetary policy to achieve the goals of macroeconomic management. Consequently, monetary policy is employed as a tool to control or influence monetary aggregates such as interest rates, money supply and bank credit, including the exchange rate, with a view to achieving set policy targets such as tackling unemployment, inflation, economic growth, etc. In this regard therefore, monetary policy plays an important role towards achieving the ultimate economic objectives of sustainable growth, full employment, price stability and a healthy balance of payments. In the pursuit of these goals, the central bank sets intermediate objectives for monetary policy. These are goals which relate to using interest rates, growth in money supply and the exchange rate to achieve the ultimate goals of monetary management. In other words, the intermediate goals are regarded as channels through which monetary policy is transmitted to the macro economy with the aim of impacting on the ultimate objectives.

The exchange Rate is one of the intermediate policy variables through which monetary policy is transmitted to the larger economy through its impact on the value of domestic currency, domestic inflation (the pass-through effect), the external sector, macroeconomic credibility, capital flows, and financial stability. Thus, changes in the exchange rate might induce changes in the relative prices of goods and services, and the level of spending by individuals and firms, especially if significant levels of their wealth are held in foreign currencies. An appreciation in the value of the exchange rate rise makes imported goods and services relatively cheap, while depreciation makes exports become cheaper to foreign buyers, thereby inducing higher competition in export markets at home. On the other hand, with depreciation, imports become more expensive and so less competitive against goods produced by domestic producers. Changes in the exchange rate therefore, have implications for individual spending and investments behavior of firms, all of which can affect aggregate demand (an important determinant of economic growth, price stability and full employment in the macro economy). However, there is a growing debate among monetary economists; whether in the current medium-term orientation of monetary policy, the exchange rate is still significant as a relevant transmission channel for monetary policy.

F. K Ohuche